

BUFFETT'S SECRET SAUCE

Now yes, of course Buffett is an excellent investor. No doubt about that at all. But what has propelled him to the top (at times) or the upper regions of that Forbes list isn't just that skill: it's also leverage. For here's the little secret about insurance companies.

To an acceptable level of detail insurance companies don't make money by underwriting insurance policies. They might make some, a little bit, they might lose a little bit. Over time, in a competitive market, we actually expect them to lose on the actual business of collecting premiums and paying out for insured losses. This doesn't mean that they all do by any means. But this is what we expect to be the general economics of the business.

For the insurance company also gets to hold that premium income until the insured losses need to be paid. This is known as the float. And that float is then invested elsewhere to produce a return. It does rather depends upon which part of the insurance industry you're in. The float doesn't last all that long in medical insurance: not when routine medical treatment gets paid out by the insurance company. At the other end, reinsurance, the insuring of insurers, the float can last decades.

So to some extent we can view an insurance company as actually a large investment fund: investing that float for however long the company gets to keep it. The actual writing of insurance policies is just a method of gaining access to that float.

Yes, I know, not wholly and entirely true in every detail. But true enough that we can use it as a bird's eye view of the industry.

So, if you were a savvy investor with a little bit of capital what would you do? Invest your own money in your stock picks? Or buy an insurance company and then apply your investment skills to investing the float? That float being some multiple of what you actually have as your own cash or capital?

What did Warren Buffett do? That's right.

This doesn't detract in any way from his achievements: it's simply an explanation in part. Buffet leveraged his investment skills with the floats of insurance companies. That's the great insight that led to becoming one of the richest men in the world.

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